$40.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

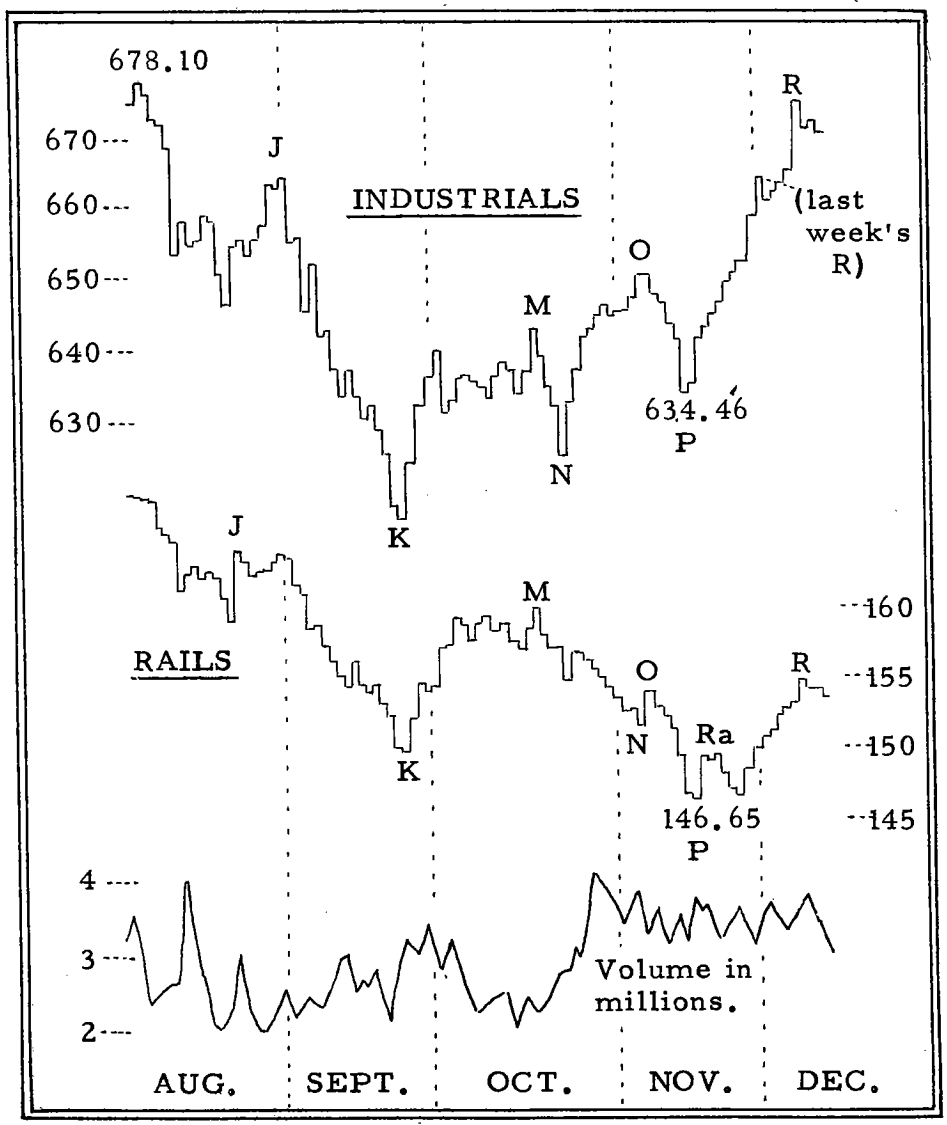
RICHARD RUSSELL
125 East 93rd Street
New York City 28

Registered with the Securities and Exchange Commission

Copyright 1959 - Richard Russell

CURRENT MARKET. The "Fabulous Sixties" are being acclaimed by the "experts" with an enthusiasm not seen since the prophets of the 1920's extolled the "New Era" of the '30's. Said Mr. Stabler in last week's New York Herald Tribune, "They used to joke about 'two cars in every garage'. Now the modern forecaster of the glories that await us would frown on such a conservative appraisal of our destiny".

Followers of Dow's Theory, nevertheless, prefer to hear the story from the market itself. And the tale told by the Averages since mid-November has been a creditable one. On the P-R advance Rails finally got "in gear" on the upside. In so doing, they bettered their minor points at Ra and O and thus approached their first major objective at M (159.99). In the last Letter (86) I noted, "A bettering of R (664.38) by Industrials with Rails moving in direction or preferably bettering their own O point (154.14) would imply an attack on the Industrial high of 678.10 established last August." On December 7 Industrials did hurdle their R point, and the following day Rails bettered O. The ensuing surge took Industrials to 675.39, just 2.71 points under their bull market high. Volume expanded on the rally, lending authority to the move.



Considering the extent and duration of the P-R rally, a correction of that move or a consolidation would not be surprising at this time. Often the Averages will form a "line" just under a critical point, and if this occurs it will be discussed in the next Letter. Danger signals at this juncture would be (1) volume falling off as Industrials approach the 678.10 high, (2) a downward zig-zag formation in both Averages, (3) divergence (one Average declining while the other advances).

Since P the tendency of volume has been to expand with higher prices and contract with lower prices, a healthy sign. The investment services and "soothsayers" have now turned overwhelmingly bullish, and by all reports the Industrials are to better their 678.10 high before this month is out. It must be

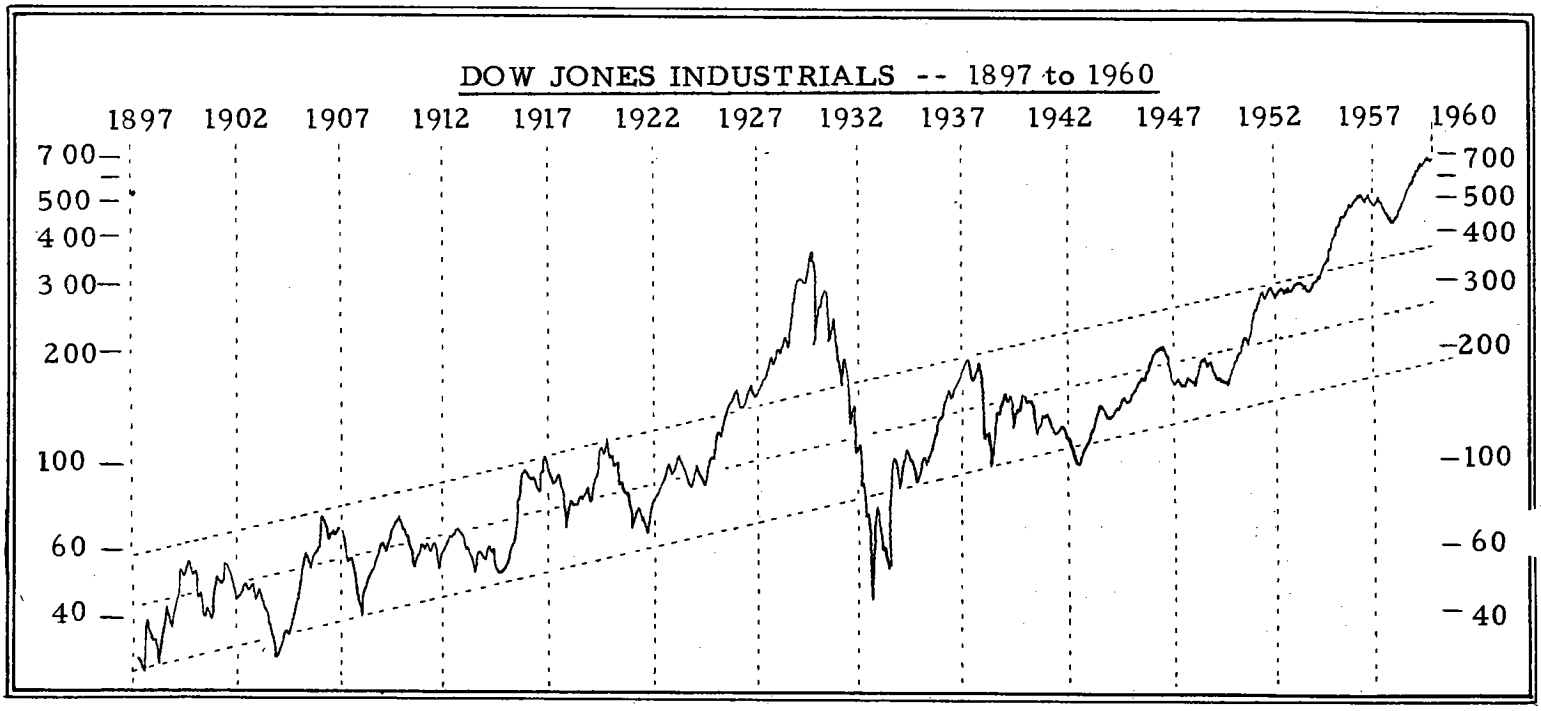
remembered that Rails are still 6 points under their intermediate peak at M, and an Industrial breakout above 678.10 unconfirmed by Rails carries far less authority than would be the case if Rails were also near their high. A new high in Industrials (on expanding volume) with Rails moving in direction would, nevertheless, set up the strong possibility of a further (perhaps sharp) advance.

It is worth noting, however, that the current rally has become more and more of a "blue chip" affair. The following statistics bear out this statement: On August 9, 1959, with Industrials just under their 678.10 high, 597 out of the 1500 Big Board issues were selling at 10% or more under their earlier 1959 highs. On December 9, with the D-J Industrials at 671.26, 900 of the Big Board issues were selling 10% (to as much as 50%) under their 1959 highs.

TACTICS. The question of tactics confronts every market student at this time. "There is no known method of forecasting the extent or duration of a primary movement" wrote Robert Rhea. For this reason we cannot know whether Industrials will (1) touch their August highs, falter, then turn down, (2) consolidate under the August highs, then continue up for a short distance before reacting, or (3) surge through the old highs and rise perhaps 50 to 150 points into the "blue yonder". But since each reader possesses a different emotional makeup and since each has a different position in the market, it is worthwhile to discuss alternatives and market tactics at this time.

The big picture is probably one of percentages. An advance in the D-J Industrials from 680 to 750 would represent an increase of 10.2%, an advance to 800 would be an increase of 17.7%. In the latter stages of a bull market's third phase the high grade D-J Industrials will usually outperform the general list; many stocks will be topping and turning down while others (in diminishing numbers) will be surging ahead. Should a panic take place at the final top, the possibility of large losses exists, and there is the additional risk of stocks' never (or not for many years) approaching their old highs again.

The above applies particularly to those readers who took profits when the danger signals appeared in early September. Many of the early sellers have not come in again, others added speculative purchases in late November when the Rails bettered their first minor highs at Ra (see chart). In Letter 80 the case for the bulls was presented. "Readers who still own stock," I wrote, "are betting that the recent recession is merely another



secondary reaction in a continuing bull market. They point to that principle of orthodox Dow Theory which states that a primary trend is taken to continue in force until countermanded by a valid reversal signal. Rather than sell too soon, they will attempt to unload if and when a bear market is actually signaled." Despite the unsatisfactory action of the rails from September through mid-November, the Dow Theory has, of course, never signaled a reversal of the primary bull trend. The bulls (at least over the shorter term) have been correct, for the Industrials have steadfastly refused to follow the Rails under the September lows (a move which would have indicated the existence of a bear market).

Readers who own large quantities of stocks now face a problem of timing. As suggested in the past, the safest procedure would be to scale out holdings gradually if the market works higher. This will result in obtaining "top dollar" on some stocks, less than top prices on others. It must be born in mind, however, that at this stage of the game stocks are not values. One test of values, for instance, is the return on investment. The average yield on the D-J Industrials is now 3.12%, the yield on the D-J 40 bonds is 5.50%. Despite the possibility of a great "blow-off" in common stocks, one must never forget Dow's maxim that over any extended period of time the trend of prices is always "towards values".

Taking the century-long view, the trend of common stocks in this country has certainly been upward. The accompanying chart of the D-J Industrials from 1897 to date graphically illustrates this point. But the chart also illustrates something else -- that the market's appraisal of values fluctuates in extended (and in some cases over-extended) swings. The center dotted line on the chart shows the approximate average value of stocks through the years.

The excesses of 1927-29 took stocks far beyond known values; the bear market which corrected the entire 1921-29 swing took stocks far below known values. In 1954 the market again tended to a rosy view of the future, and the optimism since 1958 (see chart) is comparable only to the period from 1927 to 1929. When asked how high the 1936-37 third phase could carry the market, Rhea replied, "How hot is hot?". This is the most difficult question in the analyst's books, and market students cannot expect an accurate answer. Identifying a third phase and calling the pinnacle are two different things; this is the reason I have suggested scale-selling rather than holding for the last point.

A further study of the 1897-1960 chart suggests that if the next bear market is to correct the excesses of the current bull market, that correction (or bear market) could take Industrials under the lower trend line on the chart as was the case after 1929. It is well to remember that only one of the fourteen bear markets since 1897 held above its previous bull market peak. And incredible as it now sounds, the peak of the 1942-46 bull market was 212.50!

SHORT INTEREST-AVERAGE DAILY VOLUME RATIO (S.I. Ratio - see chart, page 4)

Back in April, 1959, I sent subscribers a special study of the S.I. Ratio. This ratio consists of the total short interest on the New York Stock Exchange during a one-month period as compared to the average daily volume during that same period (total short interest divided by the average daily volume).

It was explained that the short sellers are speculating for an important drop in prices. But in order for a severe reaction (one which will be profitable to short sellers) to occur, there must be heavy downside volume. When a bull market builds up a large short position, and the market then grows dull (low volume), the shorts tend to be trapped. The reason for this is that dullness implies that the selling is over. Therefore, the larger the short position and the lower the volume, the greater the technical strength and the higher our S.I. ratio climbs.

As seen on the chart, the huge 6 million share short position of 1958 was trapped in a bull market that refused to go down. The S.I. Ratio climbed to an incredible 2.3 and remained in that area for over five months. The resultant market advance made history as the Industrials climbed 258 points to their August, 1959 high of 678.10. The S.I. Ratio has dropped considerably lower over the last year. The current 3.3 million short position (assuming it has not climbed higher during December) when compared to the recent high volume should take the S.I. Ratio under 1.0. Thus the technical strength of the great bull market is slowly diminishing, and the S.I. Ratio has fallen well into the neutral zone. Under this study, any ratio of .5 or under is considered bearish while a Ratio which holds above 1.5 is considered highly bullish.

AN INTERESTING LETTER. Many readers of these Letters are veteran Dow Theorists, and their views on the market are well worth studying. The following excerpts are from a letter received last week. The writer (an expert Dow Theorist who has written a book on the subject) made purchases when the Rails bettered their Ra point.

"Your letter No. 86 arrived today. Since your writing, the industrials have bettered "J" and the rails have topped "O". It would be possible, in following the rails, to worry along for point M, point J, and even the 1956 high; but I feel that the rails' recently established upward direction is sufficient. I would not pretend to suggest that today's situation is fundamentally similar to that of early 1935, but there is a possible parallel in the actions of the two averages at these two instances.

As you know, I am aware of some of the wrong things about buying here. Monday's active list was of very low quality; the odd-lot short ratio has gone down again; and the typical quiet spot on a decline has been notably absent. In this stage of a market, however, one cannot count too heavily on finding such signs. There is more risk in buying here than there was further back, but the greatest risk at the moment seems to be that carried by the shorts.

Yes, money is dear. But in 1929 my father left his credit balance with a respectable Philadelphia brokerage house at 6%. I will never know what they were charging for it.

I am watchfull, and will let go fairly readily, but meanwhile it's a nice ride.

Sincerely yours,

A.M.S. - Newtown Square, Pa."

(Letter 87 written December 14th at noon.)